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STATE PASS FEDERAL RESERVE BOARD FRO JOHNSON/SCHINDLER; SF FRB
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TREASURY FOR ADAMS, AND OASIA-DOHNER, BAKER, CUSHMAN
USDOC FOR ITA A/DAS MELCHER, MCQUEEN
NSC FOR HUBBARD AND TONG

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SUBJECT: FRB TOLD: NO OVERHEATING AND BUSINESS GOOD

REF: A) 06 SHANGHAI 7112, B) 06 BEIJING 24442, C) 06 SHANGHAI 7129, D) SHANGHAI 25

SHANGHAI 00000026 001.2 OF 005

(U) This cable is Sensitive But Unclassified. Not for transmission outside of USG channels.

¶1. (SBU) Summary: A Federal Reserve Bank (FRB) delegation led by Governor Kevin Warsh met with economic analysts, U.S. business leaders, and equity market analysts during a December visit to Shanghai. Economic analysts offered the contrarian view that China's economy was not overheated, and, in the short term, would continue to maintain its record growth. In the long term, however, rich-poor gaps, failing educational and health services, environmental degradation, and a bankrupt pension system could lead to dramatic political and economic instability. Business leaders were generally upbeat, noting that their biggest concern was finding and retaining qualified employees. Equity analysts said China's stock market had regained much of the ground it lost during lengthy reforms and were bullish on continued gains. They believed mergers and acquisitions (M&A) would play a major role in China's continued economic growth, but were concerned that foreign players could be left out. End summary.

¶2. (SBU) As part of a recent visit to China to assess macroeconomic and financial sector development, Federal Reserve System Governor Kevin Warsh, San Francisco FRB President Janet Yellen, and VPs Reuven Glick and Teresa Curran visited Shanghai December 1-2 to meet with analysts and business leaders, including Citibank CEO Richard Stanley (Ref A), accompanied by Pol/Econ Chief and Econoff. The delegation met separately with People's Bank of China Deputy Governor Xiang Junbo.

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China's Macroeconomic Situation: Good Now, Bad Later

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¶3. (SBU) The delegation met with CLSA China Macro Strategist

Andrew Rothman, BHP Billiton China Economist H. Robin Bordie, and Research Works President Hugh Peymann to discuss China's macroeconomic conditions. Rothman and Bordie acknowledged that their view on China's economy differed from the consensus. From their perspective, China did not have an overheating problem; rather, its biggest problem was "too slow growth" to balance out increasing social stability pressures. The analysts forecasted that strong economic growth for the next seven years would further widen the rich-poor gap. By 2013, this income-disparity could lead to widespread social instability.

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How Can It Be Overheated if We Can't Feel the Heat?

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¶4. (SBU) Rothman said that in recent years there had been "no real inflation in China," nor symptoms of overheating. While fixed asset investment (FAI) had continued to grow, this had not led to overheating. Rothman estimated China's year-on year FAI growth at 25 percent of GDP -- not excessive when compared to post-war Taiwan and South Korea. China's problem had not been too much investment, but rather the poor quality of some investments. Rothman attributed the quality problem primarily to the control the Party still exerted on banks, as well as banks' inability to conduct adequate risk management.

¶5. (SBU) According to Rothman, China's monetary policy had not been interest-rate sensitive. China would need to increase its interest rates by 300 basis points to have any impact on the economy. Therefore, Bordie said, the government used moral suasion with banks to reduce their lending rates. She said this

was done by "the Party calling bank managers to tell them what to do." Typically, this moral suasion had been a three-step process. The first step was the issuance of a White Paper identifying a problem. The second step was issuance of a more "shrill" White Paper calling for drastic measures. The third step was "arresting someone in Inner Mongolia." It was only then that individual bank managers would take action, for example to reduce lending. (Note: Bordie's views were similar to those expressed by another contact in Ref C that actions taken against Party Secretary Chen Liangyu were in part an economic tool to persuade local governments to slow down, in lieu of effective macro policy. End note.)

What Keeps China's Leaders Up at Night?

¶6. (SBU) According to Rothman, the issue that "keeps China's leaders up at night," was the poor--both urban unemployed and those living in extreme poverty in rural areas. According to Rothman's research, the urban unemployment rate, while officially only 4 percent, was probably closer to 8 percent and possibly as high as 16 percent. These unemployed were mainly unskilled rural migrants. Rothman added that, despite China's best efforts to reduce rural poverty, there were still more than 150 million people living at less than $1/day. Bordie said that poverty in China had been essentially a rural issue, with few real urban slums. However, this had started to change with the massive migration from rural to urban areas underway in China.

¶7. (SBU) According to Bordie, China's leaders had made a "Faustian bargain" to remain in control. The terms of this agreement were that they "had to keep everyone happy," with happiness defined in economic terms so they would not question their inability to participate politically. She said that the next five years would see huge investments in China's social infrastructure -- education, healthcare, and pension systems -- as well as continued attempts to rein in corruption. In the short term, these steps would prove effective. By 2013-2015, however, a massive and obvious rich-poor gap, a generation of wealthy individuals not beholden to the Communist Party for their success, and a substantial decline in the working-age population would create an environment for significant social instability and challenges to the Communist Party's monopoly on power.

¶8. (SBU) Rothman added that the government had realized that it now had less control over its people than it had prior to a decade of market-based reforms. The market-based economy had "forced the development of personal freedoms." These freedoms were, in turn, creating a sense of individual entitlement. Peymann agreed that, unless the government was able to fix China's healthcare and pension systems and improve its environment, by 2013, political instability would result from urban "rich" who would feel entitled to a better life than they would be able to attain.

Doing Business in China

¶9. (SBU) Starbucks China President Wang Jinglong, American Express Vice President for Business Services Mary Crawford, UPS Director Tan Sockhwee, Dell (China) General Manager Yvonne Pei and U.S. China Business Council's Godfrey Firth briefed the delegation on experiences of U.S. companies in China. While generally upbeat on their respective companies' prospects in China, business leaders noted some policy trends that were intended to favor Chinese over international companies. The

high cost of training and retaining staff able to work in an international environment was also a common theme, with several noting difficulty finding staff with competent English skills.

Starbucks: Symbol of Success

¶10. (SBU) Starbuck's Wang Jinglong said he believed the Chinese government was still one of the most pro-business governments in the world, but noted that its "Fourth Generation Leadership" had subtly, but dramatically, shifted direction from the previous profit-driven model to an economic model that emphasized the need to respect China's "land, culture, and people."

¶11. (SBU) According to Wang, having a Starbucks had become seen

by China's local political leaders as a sign of progress, that a town or city "had made it." He said that wherever he went in China, "the mayor always has time to meet with me." Starbucks China had also carried out active corporate social responsibility programs to build goodwill, with over $5 million USD in donations to educational institutions. As a result, Starbucks had been able to cut through bureaucratic obstacles in places such as Xian, where recently it only took three days to "resolve six months of issues." There were already 200 Starbucks in China and Wang anticipated continued strong growth.

¶12. (SBU) Wang noted that 80-90 percent of its baristas in China were college graduates and that while China's labor market was very big, its pool of experienced, trained workers was quite small, leading to intense competition. He said that in a market like Shanghai's, individuals under 30 changed jobs on average every 17.5 months.

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Dell: Impacted by China's Self-Innovation Drive

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¶13. (SBU) While Dell had 7,000 employees in China and purchased $20 billion USD worth of computers, it had recently been negatively impacted by China's recent push to support Chinese "self-innovation" companies (ref B) according to Yvonne Pei. Pei said that in Dell's eight years in China, 80 percent of its computer sales had been to institutions, such as Chinese government offices. She said that recent changes to the bidding process meant that Chinese computer companies were awarded extra points for being "Chinese self-innovation" companies. These extra points meant that Dell's bids were no longer competitive, despite the fact that Dell offered lower prices and had an research and development center in Shanghai that employed approximately 1,000 people in addition to a manufacturing plant located in Xian.

UPS: All Deliveries Are Local

¶14. (SBU) Tan Sockwhee noted that UPS opened its first China-based UPS Express retail store in Shanghai in August 2006 and was now focused on trying to instill the "UPS culture" in its rapidly growing workforce which had increased from 400 employees in 4,000 the past year. Tan said that one of UPS's biggest challenges was retaining qualified employees due to the

high demands for trained employees. Tan described some of the complications UPS had experienced in entering the Chinese domestic postal market, saying that "China is not an open field." Other issues UPS faced were securing landing rights for the flights it needed to support its volume, and inter-city transportation problems where, for instance, a UPS truck with a Shanghai license plate was not permitted to enter another municipal area such as the nearby city of Suzhou.

AMEX: Focused on Outsourcing Services

¶15. (SBU) American Express's Mary Crawford said Amex's bank card sector was "very undeveloped in China." (Note: Amex has been classified by the Chinese government as a travel services company and thus is limited in its ability to issue bank cards. End note.) Amex's proposed plan to open a business process outsourcing services operating center here, however, had been warmly welcomed. Amex had been encouraged to open the operating center in the western city of Chengdu, Sichuan Province, but had not yet settled on a location due to the necessity of finding a critical mass of potential employees with adequate English language skills.

Equity Market Meeting

¶16. (SBU) The delegation was briefed on equity market developments by: Peter Alexander, Principal of Z-Ben Advisors, a privately-run information clearing house for China equities information; Ian Midgley, Chief Investment Officer of Lombarda China Fund Management, a fund management joint venture company with Italy's Banca Lombarda holding a controlling stake of 49 percent with two Chinese partners, Guodu Securities Company and Pingding Shan Coal Company; and Robert Theleen, Chairman of ChinaVest, a Shanghai-based venture capital firm that had been in China since 1981 with assets of 30-40 billion USD.

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Stock Markets: Rising Up on a Sea of Liquidity

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¶17. (SBU) According to Alexander, China's recent stock market gains had been largely driven by excess liquidity, with two trillion U.S. dollars worth of money "sitting idly in banks." Midgley agreed, but added that the Chinese Security Regulatory Committee (CSRC) had also recently resolved major structural issues that had contributed to several years of historic lows (See Ref D).

China's Improving Regulatory System

¶18. (SBU) Theleen said that China's regulators were "young -- in their 30's to 50's", many with post-graduate degrees from universities outside China. He said the regulatory process in China had been in the process of shifting from the state as owner-operator-regulator under a Ministry to a more independent

regulatory system. He added that now, thanks in large part to WTO requirements, when a task-force was formed by the Chinese

government to design a new law or regulation, these newly-empowered regulatory bodies would join in policy-level discussions.

Market To Be Driven by M&A's

¶19. (SBU) Midgley said that for the foreseeable future, the market would be driven by mergers and acquisitions (M&A). He noted that there was enormous scope for M&A's, pointing out, for example, that China's top steel producer, Bao Steel, only represented five percent of China's steel production capability. The underlying political question, however, was whether foreign companies would be permitted to participate. According to Theleen, there were 40 multinational firms with more than one billion USD each who were ready to invest in China, but who were hesitant about current policies that seemed to be trending away from China's recent open-door policy. Midgley added that, in addition, provincial and city-level governments often owned companies and thus had enormous power and interest in maintaining their own brand-names. This might also be a factor in slowing down the pace of China's M&A activity.

¶20. (U) The delegation did not have the opportunity to clear on this cable.
JARRETT